Manulife Asset Management

MONTHLY MACRO VIEW

Tremors in Turkey, but where on the Richter scale?

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Markets staged a mild rebound in July. Positive gross domestic products (GDP) reports from the US and China and an easing of trade tensions between the US and EU were the key supports. The respite for investors proved brief. Turkey's long-festering structural problems erupted into a currency and financial crisis on 11 August, with US sanctions and import tariffs the immediate catalysts. The question for investors now is where should Turkish tremors rank on the Richter scale?

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01 Turkey crisis in August, July market review

The emergence of external financing difficulties at some stage was only a matter of time, given Turkey's unwise pursuit of growth-at-all-costs ahead of the June elections, despite rising inflation and rapidly expanding external deficit. What took investors by surprise is the magnitude of the accompanying sell off in markets around the globe, with EM and European equities hurt the most and only the US holding up.

We do not regard Turkey's economic problems as being common to other EM economies. With regard to direct economic spillovers, Turkey is too small to be of systemic importance to the global economy, or even for Europe, Turkey's number one trading partner. What Turkey has impacted the most is global sentiment, which suggests that the indiscriminate selling of EM and other markets is overdone.

Cheap valuations offer attractive long term entry points for bottom up stock pickers. For the time being, markets are expected to stay volatile and may correct further, as anxious investors are on the lookout for who will be the next Turkey. It is notable that just as the Credit Suisse global risk appetite gauge has fallen into the "panic zone", global industrial momentum has begun to improve after losing steam in the first half. Cheap markets and an improving economy suggest "Buy", not "Sell". Asian markets falling for reasons unrelated to Asia surely represents an opportunity.

July Market Review [1]

- **Equity Performance**

Global stock markets recovered from oversold conditions, encouraged by solid GDP reports from the US and China. There was even some positive news on trade, as the EU and Japan announced the largest ever bilateral trade agreement on 16 July, while the US and EU agreed to a truce after Jean-Claude Juncker's visit to Washington later in the month[2].

Market breadth concerns were tested in July when a few large-cap US tech stocks suffered steep share price declines after missing elevated earnings expectations. The market took this in its stride with no contagion across the sector, which was helped by other tech names posting strong second quarter results[3].

The S&P500 rose 3.7%, taking the year-to-date (YTD) return to 6.5%. Global stocks returned 3.1% (MSCI AC World), with the Developed World up 3.2% and Emerging Markets up 2.3%. Latin America made up some of the lost ground in July with a rise of 9.2% (MSCI, US dollar).

At the global level, Value (4%) outperformed Growth (2.9%) in July, with balance sheet risk a key determinant of overall performance. Some hitherto lagging global sectors such as telecoms (3.6%), financials (4.3%), and healthcare (6.2%) also outperformed.

One oft-heard comment is that the breadth of this rally has been unusually narrow. Surprisingly, Russell 1000 returns broken down by market cap quintile (1 = the largest 20% of stocks) reveal that it is the midcap stocks that have outperformed in 2018 (quintiles 2, 3, and 4).

- **Bonds**

Global curves steepened in late July. Over the month the US 10-year government bond yield rose by 12 basis points (bps) to close at 2.97%. Momentum has since faded and a successful break above 3.0% does not appear imminent.

G7 yields ended last month up across the board: German yields moved up from 20bps to 39bps. The Japanese

[1] Source: FactSet, Manulife Asset Management, Societe Generale Global Quantitative Research, 31 July 2018.
[2] Source: "US and EU declare ceasefire to trade war", Financial Times, 26 July 2018.
[3] Source: See "Global Equity Market Arithmetic", Societe Generale, 1 August 2018.

yield posted the sharpest rise in two years after the Bank of Japan made some "tweaks" to monetary policy, widening the target range around zero for the 10-year yield. Italian sovereign yields rose more than corporate yields due to the uncertain European Union (EU)/Italian political outlook. Higher global yields may offer some encouragement to global bank stocks.

Chart 1: July market snapshot [4]

MSCI equity indices	Total Return in US dollar (%)		
	July 2018	1 year	Year-to-date 2018
All Country World Index (ACWI)	3.05	11.55	2.91
US	3.59	16.27	6.59
Europe, Australasia, Far East (EAFE)	2.47	6.93	0.04
Europe	3.34	6.30	0.54
Japan	0.40	9.12	-1.46
Emerging Markets	2.28	4.74	-4.37
Asia Pacific ex-Japan	1.14	5.59	-2.96
Lat Am	9.24	1.04	-2.76

Currencies/Currency indices	Price return (%)		
	July 2018	1 year	Year-to-date 2018
US dollar index (DXY)	0.09	1.82	2.64
JP Morgan Asia dollar index (ADXY)	-1.21	-1.24	-3.62
EUR/USD	0.79	0.01	-2.07
GBP/USD	0.17	0.28	-2.48
JPY/USD	-0.83	-0.87	0.89
RMB/USD	-3.09	-1.55	-4.77
SGD/USD	0.20	-0.33	-1.90

Bond indices	Total Return in US dollar (%)		
	July 2018	1 year	Year-to-date 2018
Citi World Government Bond Index	-0.41	-0.36	-1.35
Barclays Global Aggregate	-0.17	-0.48	-1.62
Barclays Global High Yield	1.65	1.26	-0.91
Barclays EM USD Aggregate	1.65	-0.26	-2.25

Commodities	Price return (%)		
	July 2018	1 year	Year-to-date 2018
Brent crude	-6.53	41.03	11.04
Reuters/CoreCommodity CRB commodity total return index	-2.75	8.13	1.39
Gold Futures	-2.46	-3.39	-6.54
Copper Futures	-4.05	-2.08	-14.21

- **Currency**

In foreign exchange (FX) markets it was the RMB (renminbi) that came under the spotlight in July[5]. We believe China's central bank, the People's Bank of China (PBoC), does not wish to see a further sharp currency decline in such a volatile environment. Beijing does not intend to make the RMB a weapon in the struggle with the US over trade, though the recent market-driven fall is clearly helpful in this respect.

Our view on the RMB was supported by the PBoC announcement of an increase in the risk reserve requirement for onshore banks' forward FX sales from zero to 20%[6]. This is the first policy step aimed at reducing downward pressure on the RMB. The central bank is prepared to "lean heavily into the wind" in order to keep the onshore RMB (CNY) below 7.0. If the USD/CNY remains close to 7.0, then this would amount to almost a full hedge against US import tariffs[7].

In August it is the US dollar that is centre stage, as the beneficiary of a "risk-off" flight to safety. Month-to-date (MTD) the dollar index (DXY) currency basket has appreciated 2.3% to 96.7[8]. The dollar and US Treasuries are the preferred "safe haven" assets in the current turbulence. Among other safe havens, the Japanese yen is up 1% but gold and the Swiss franc are down. In the short term, the US dollar and Treasuries can expect to receive further inflows as long as trade frictions persist, driving the DXY higher. This is a headwind for emerging market debt and equities, but one we think will be temporary. The medium term direction for the dollar should still be lower, once safe haven flows stall, given the US need to finance expanding trade and fiscal deficits.

[4] Source: Bloomberg and Manulife Asset Management, as of 31 July 2018. Total returns in US dollar, all currencies returns are versus US dollar. All commodities' price returns are calculated in US dollar. Past performance is not indicative of future results.
[5] Source: "Asian FX Focus: Tolerating flexibility", HSBC Global Research, 3 July 2018.
[6] Source: People's Bank of China, 3 August 2018.
[7] Source: See "China A-share Market Strategy," Credit Suisse, 9 August 2018.
[8] Source: Bloomberg, as of 17 August.

- **Commodities**

Most commodity prices weakened in July on trade war fears and weaker Chinese monthly economic data for June. HSBC's broad commodity price basket fell 2.0%[9]. Commodities sensitive to China demand fell the most e.g. nickel down 14% and zinc down 21%. So far in August, we have seen further sharp falls in a broad range of commodities.

July recovery in equities overwhelmed by the crisis in Turkey

Markets in the first half of August confirmed the July recovery was just a bounce. The scale and timing of the currency and financial crisis in Turkey which erupted on 11 August took markets by surprise and investor sentiment towards EM markets is expected to remain fragile and volatile in the near term. Confidence in EM debt and equity markets will take time to recover. With a weaker seasonal profile until October, a cautious investment stance is recommended for investors with a short term horizon.

Unfortunately, the Turkish bubble burst at a particularly inconvenient time. Viewed in isolation, it should not have impacted market sentiment as much as it has. After all, Turkey accounts for just 3% of Eurozone exports, has a weight of less than 1.0% in the MSCI Emerging Markets index (3.5% in the JPM EBIG sovereign bond index). European bank loans to Turkey are around 1.0% to 2.7% of French and Spanish total bank assets[10], so non-performing loans should prove manageable, especially as much of the exposure comes via local subsidiaries rather than external loans. Euro area exports to Turkey of US$5.8 billion, though relatively small, are nevertheless 7.5 times greater than US exports to Turkey of US$0.8 billion[11]. In terms of economic costs the US has little to lose from employing sanctions against Turkey. The political costs of President Trump's "shoot first" diplomacy may be potentially far greater.

Unlike the Asian crisis, Turkey's economic problems are specific to Turkey. They are mostly the result of weak institutions, unsustainable economic policies, too much external debt, a ballooning current account deficit and troubled domestic politics. They are not common to a larger group of important EM countries, although there are a few other minor EM countries such as Venezuela that could be placed in the same "avoid" bracket.

The reasons why Turkey is having such a big impact currently are (1) it happened at a time of rising investor nerves due to worsening US-China trade relations, Middle East turmoil, Iran sanctions etc., (2) there is no quick fix for such severe structural problems, (3) important political relationships between Turkey and Europe and the US are under severe stress.

There can be no solution to Turkey's economic crisis without either deep austerity and an International Monetary Fund (IMF) program, or stringent capital controls. President Erdogan may well resort to the latter – he is not exactly spoilt for choice. Initial approaches to Russia, China and the EU for financial assistance by Turkey are unlikely to be sufficient – the current account alone requires around US$5 billion of new finance each month.

While the major risks to equities in 2018 – higher US interest rates, US dollar strength and trade fears – are all still with us, they should be partially discounted by now. Provided US-China trade relations do not worsen –the single biggest macro risk according to the latest fund manager poll from BoAML – the recent volatility should gradually subside.

Range bound markets are probably the best one can hope for in the short term. Beyond that, if any EM market is going to bounce, it ought to be China following the recent fiscal and monetary policy easing and renminbi depreciation. So keep a watch on resistance levels for the main Shanghai and Hong Kong China indices. Once the current geopolitical noise dies down, we still believe a combination of stable global economic growth, low inflation and good earnings gains in 2019 will make for a positive investment environment.

[9] Source: See "US Rapid Response - Producer Prices", Capital Economics, 9 August 2018.
[10] Source: "Europe's Turkisk Plight", TS Lombard, 13 August 2018.
[11] Source: External Trade, ECB, www.ecb.europa.eu, 17 August 2018.

Trade war: How much is theatre, how much is real?

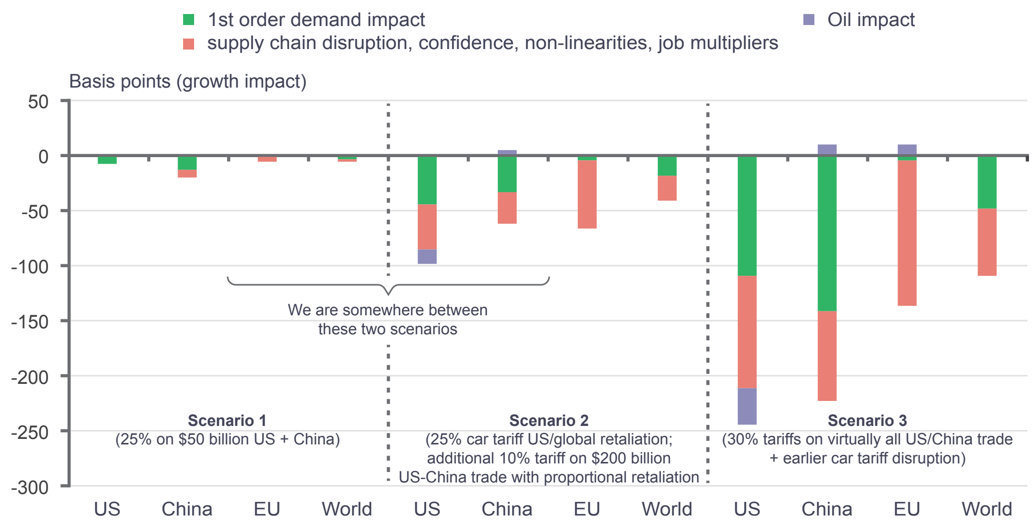
The "Trade Wars" saga continues to screen at full theatres around the globe. How much is theatre, for domestic political consumption, and how much is real? That is the key question for investors. Unfortunately, it looks as if US-China trade relations are going to remain troubled for some time.

The macro economic impact of the first US$50 billion of import tariffs is expected to be small. Some adverse consequences are already becoming visible. In the case of a few commodities such as soybeans or steel, the price impacts have been large.

For many intermediate inputs it will take more time for higher tariffs to work their way up the production chain and become visible in higher consumer and capital goods prices. The earlier US tariffs on steel and aluminium imports are already pushing up input costs. Intermediate demand inflation for steel mill products rose to 12.2% in July, while the PPI inflation rate for overall core goods intermediate items rose to a near 7-year high of 5.3%, according to a report from Capital Economics[12].

Chart 2: Where do we stand with the US-China trade war?

Simulation estimates of the impact on regional and global growth of different trade tariff scenarios[13]



Note that estimates of US-China tariff costs in the media often refer only to the direct or initial impact. They make no allowance for trade diversion or tariff evasion e.g. when US farmers export soybeans to Brazil which re-exports them to China, adding 10% to shipping costs but avoiding China's 25% import tariff.

Chart 2 shows three different trade scenarios from the economists at UBS. These estimates employ an economic model to estimate the "multiplier", or second round income and demand effects of the tariffs; plus the harder to model impact from lower business confidence and disruption to global supply chains.

A key point which emerges from Chart 2 is that the second round impact of import tariffs is greater than the initial impact in each scenario. Economists dislike trade barriers because they invariably worsen the output/inflation mix – real output falls and prices are increased whenever trade tariffs are imposed.

This means the macro-economic costs of US tariffs on Chinese imports will not be felt until well after the November mid-term elections. The IMF thinks the longer term damage from disruptions to global supply chains will become much more apparent by 2020. If there is no trade deal between the US and China, tariffs could have a strong bearing on the next US presidential election.

[12] Source: See "US Rapid Response - Producer Prices", Capital Economics, 9 August 2018.
[13] Source: UBS, July 2018.

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02 Late cycle equity returns – positive but lower

It is now 10 years since the last global recession. And in the US, the S&P 500 has enjoyed the second longest rally since 1945 (March 2009 to July 2018, 112 months, versus July 1990 to March 2001, 128 months). But can the rally continue for much longer? Is it now so late in the cycle that the majority of equity returns are likely behind us, with little left for investors to look forward to? In what follows we look at the returns that investors have typically experienced in the later stages of the business cycle.

The late cycle is usually accompanied by rising pressure on global interest rates. This is an issue of great concern to investors in 2018, as the Fed seems determined to proceed with more rate hikes in 2019 and 2020 than the market believes will occur.

One may think of the stocks most negatively correlated to Treasury yields as "bond proxies" and those most positively correlated as "bond hedges". The late cycle phase is when Quality stocks often exhibit a negative correlation with yields – bond proxies tend to underperform. The more cyclically-sensitive Value stocks on the other hand have consistently shown a positive correlation with yields in the mature stages of the business cycle.

Chart 3: Relative Performance of bond proxies (Quality stocks, more bond yield sensitive) versus bond hedges (Value stocks, less bond yield sensitive) [14]

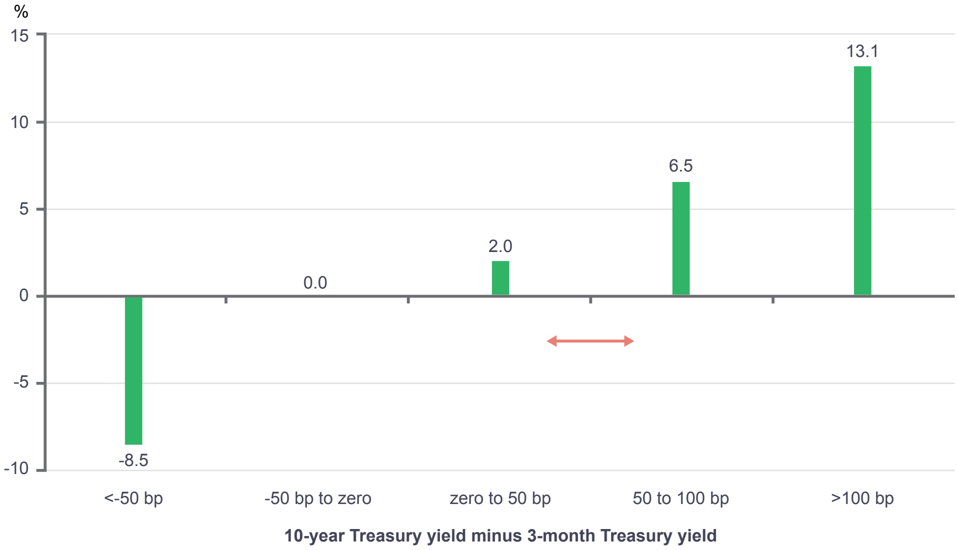
The chart maps the performance of the bottom and top 10% of MSCI US and MSCI Europe, Australasia and the Far East (EAFE) stocks screened by their prior 60-month correlation with US Treasury yields.

Analysis by the quant team at Societe Generale shows that Quality stocks tend to have a bigger index weight than Value stocks. For the S&P 500, their equal-weighted Value universe amounts to 15% of total market cap compared to 30% for Quality[15]. Quality experienced a greater re-rating than Value during the earlier cycle phases when QE acted to persistently depress bond yields.

There is a risk that if bond yields head higher, the headwind for expensive Quality stocks could overwhelm the cyclical earnings per share (EPS) growth required to push Value stocks higher. It has certainly been the case that Quality has underperformed the broad market in the US and Europe since the Fed decided to raise rates for a second time in December 2016. (As shown in the shaded area in Chart 3; As of July 2018, MSCI US and MSCI EAFE returned 28% and 23% since December 2016.)

[14] Source: Societe Generale Quantitative Research, July 2018.
[15] Source: Societe Generale Global Market Arithmetic, 16 July 2018.

Chart 4: Returns in the "late cycle" can still be good [16]



The chart – from NBF – gives perspective on US equity returns in the later stages of the business cycle. Historically, returns are lower but are still positive.

The National Bank of Canada examined US equity returns in the mature stages of the business cycle according to the prevailing shape of the yield curve (YC). The results of their analysis appear above in Chart 4. Historically, late cycle S&P returns have been: (i) decent (6.5% on average) when the 10-year Treasury yield minus the 3-month Treasury yield fell within a 50 to 100 bps range; (ii) low but still positive (2.0% on average) when the YC was flat (0 to 50 bps range); and (iii) decidedly negative (-8.5% mean) in periods when the YC has inverted.

How concerned investors should be will also depend on where exactly we are in the mature stage of the cycle. We believe there is still time left for investors to make money from equities in this cycle. Looking at the five instances of yield curve inversions since 1978, the S&P 500 did not peak until eight months later on average, while recession did not begin until 17 months later, on average[17]. One important caveat is that the peak response is clearly bipolar, so that although the average is eight months, on three occasions it was coincident (zero to two months) and on two occasions it has been much longer (18 to 20 months).

Nevertheless, most recession gauges are not even flashing amber. So despite the increased media talk of the next recession, we think it is too early to worry about the end of this cycle. With the important caveat, however, that there is no external shock such as an oil price spike. That a risk that has been increased by the US decision to renew sanctions against Iran at a time when the oil market has only a slim margin of spare capacity.

Chart 5: The S&P 500 peaks after the yield curve inverts [18]

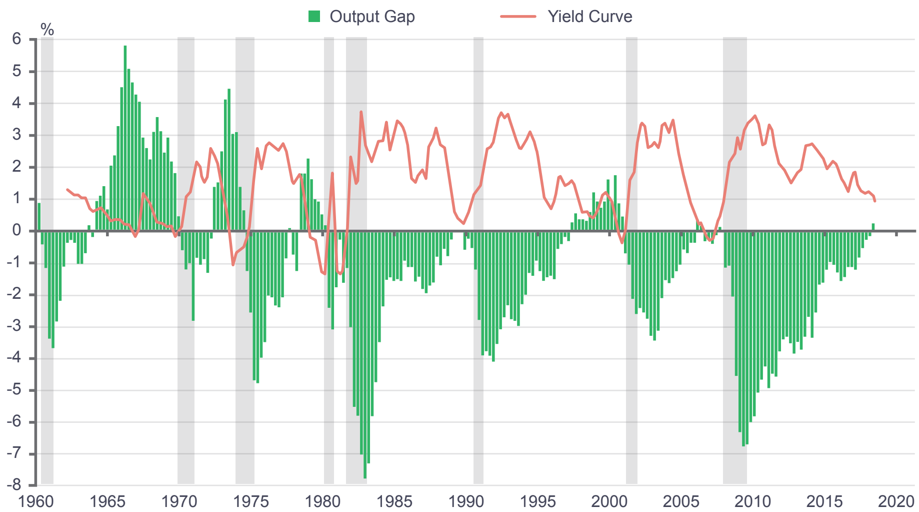
Yield Curve Inverts	Equity Market Peaks	Month to Peak	Recession Begin	Months to Recession
September 1978	September 1978	0	February 1980	17
September 1980	November 1980	2	August 1981	11
January 1989	July 1990	18	August 1990	19
February 2000	March 2000	1	April 2001	14
February 2000	October 2007	20	January 2008	23
	Average:	**8**	**Average:**	**17**

16 Source: National Bank of Canada Financial Markets, August 2018.
17 Source: "Equity Market as Vigilante: More Worried About the Fed than Trade", Strategas, 22 June 2018.
18 Source: Strategas, June 2018.

US economists have drawn attention to the closing of the output gap in the US as having increased inflation risks which in turn will force the Fed to keep on raising interest rates "until something breaks". While the latest estimates of the US output gap from the Congressional Budget Office (CBO) suggest it has turned positive (Chart 6), we would caution against reading too much into this. The so-called output gap is not based on any empirical gauge of full capacity production, but is merely the deviation from an uncertain trend.

Not only is there a statistical lag of 12 months or more between measures of the output gap and US inflation, the historical evidence shows only a very weak (statistically insignificant) relationship with inflation when the gap is moderate (less than + or – 2.0% of GDP). A positive output gap is something to monitor, as with all potential gauges of inflation pressure. But it is not a valid reason for investors to be reducing their strategic commitment to equities at this point.

Chart 6: Yield curve worries at this point appear overdone [19]



This chart shows that the US yield curve (10-yr less 3-mth T-bill), despite the media angst, is not particularly flat for this stage of the cycle. The output gap – an advance indicator of future inflation pressures – has only just turned positive.

Lastly, while history reveals it is possible to experience an "earnings recession" without an economic recession, there has never been an economic recession when earnings were still growing strongly. S&P earnings were broadly flat in 2014, 2015 and 2016. That did not prevent the bull market in stocks from continuing, thanks to the acceleration in global QE during this period.

Even if US rate hikes rule out multiple expansion, double digit earnings growth in 2019 may still leave enough room for decent equity returns. Provided, of course, that enough progress can be made in negotiations between the US and its major trading partners to avoid a global trade war, which is still our base case scenario.

[19] Source: National Bank of Canada Financial Markets, August 2018.

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